



## OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan  
*County Executive*

Bruce Romer  
*Chief Administrative Officer*

May 16, 2002

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended March 31, 2002. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

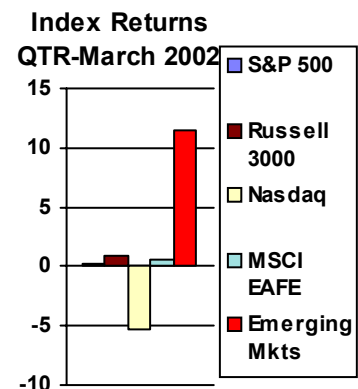
### History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 6,024 active members and 3,989 retirees participating in the System as of June 30, 2001.

### Capital Markets and Economic Conditions

On April 17th Chairman Greenspan stated, "The strength of the U.S. economic recovery is still uncertain and inflation pressures are largely absent which means Federal Reserve officials probably won't have to raise interest rates any time soon." At their last meeting, policy makers left the benchmark overnight bank lending rate at a 40-year low of 1.75%. It now appears that the preliminary GDP numbers will show annualized growth of about 6% in the first quarter. Yet the sectors of the economy that were hit the hardest last year, technology and telecommunications, are showing few signs of recovery, as demonstrated by IBM's announcement that first quarter revenues and earnings were substantially lower than expected.

Although the markets rallied in March, as the fervor over accounting issues subsided and economic releases improved, the March quarter saw the broad markets, as represented by the S&P 500 and Russell 3000 indices, relatively flat. The Nasdaq index of smaller companies rebounded in March; it was up over 6%. However, for the quarter the return was still negative. Smaller companies generally perform best when the economy is emerging from an economic downturn.



## QUARTERLY REPORT

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The equity markets have experienced a slow start in 2002, but strong earnings gains are possible later this year as final demand rebounds even as companies have trimmed costs. This should enable margins to recover and comparisons will be easy against the very poor earnings posted in the second half of 2001. Our combined domestic equity performance for the quarter was a return of 2.74 percent, outperforming the Russell 3000 benchmark index return of .97 percent by nearly 170 basis points.

Internationally, in just a matter of a few months, markets have gone from hoping for a bottom in the global recession to largely discounting a full near-term recovery. As such, any evidence that a U.S. led recovery was filtering through to the rest of the world tended to bolster a variety of cyclical names, everything from basic industries to autos to luxury goods. Japan modestly outperformed Europe. However, technical factors related to the closing of their fiscal year, rather than fundamentals, largely fueled the Japanese market. Taking their cue from the Federal Reserve, central bank easing cycles appeared to be over in much of the world with the exception of Japan. The European Central Bank held rates steady as inflation and money-supply growth were running higher than the central bank's target. The combined performance of our international equity managers was a return of 2.95 percent compared to the 1.64 percent return of the benchmark index.

Within the fixed income sector mortgage-backed securities were the best performing instruments, while Treasuries underperformed due to the recent data suggesting that the economy is strengthening. During the March quarter, interest rates rose across the yield curve. While the yield curve flattened in anticipation of a less accommodative Federal Reserve, longer duration Treasuries underperformed intermediates as Treasuries realized negative returns. The investment-grade corporate sector was exceptionally volatile during the quarter. Fear of accounting improprieties similar to the Enron debacle, and/or a heavy reliance on the short-term commercial paper market for funding, impacted several of the largest and most liquid issuers, including Worldcom, Tyco and General Electric. The System's combined fixed income performance was .02 percent compared to the Salomon Brothers Broad Index return of .08 percent.

The total return achieved by the Employees' Retirement System's assets for the quarter was 1.79 percent compared to the System's benchmark target return of .83 percent. The asset allocation of the System's assets at March 31, 2002 was: Domestic Equities 50.3%, International Equities 15.3%, Fixed Income 33.7%, Cash .1% and Real Estate .6%. Fiscal year-to-date performance was a loss of (1.23)% compared to the System's policy benchmark loss of (.68)%.

### **Additions**

The primary sources of additions for the ERS include member and County contributions and investment income. The following tables show the source and amount of additions for the quarter ending March 31, 2002 and Fiscal Year to date.

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#### **Employees' Retirement System Contributions and Investment Income (millions)**

	<b>Qtr Ended 3/31/02</b>	<b>Fiscal YTD</b>
Employer Contributions	\$ 9.7	\$ 29.3
Member Contributions	3.3	9.4
Net Investment Income (Loss)	29.0	(25.1)
	\$ 42.0	\$13.6

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### ***Deductions***

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

#### **Employees' Retirement System Deductions by Type (millions)**

	<b>QTR ended 3/31/02</b>	<b>Fiscal YTD</b>
Benefits	\$21.5	\$63.5
Refunds	.1	.5
Administrative Expenses	.5	1.3
	<b>\$22.1</b>	<b>\$65.3</b>

### ***Outlook***

The economic recovery is taking on a V shape in its initial phase as final demand is holding up better than anticipated. The common theme of recent comments by several Federal Reserve officials is that they intend to take advantage of the current low inflation environment to give the economy running room to strengthen before they begin to "re-normalize" interest rates. The implication is that the Fed remains on hold until the second half of 2002, even if signs of strong growth continue to emerge.

While the System has exceeded the actuarially assumed return of 8% annually for the five and ten year periods ended March 31, 2002, investment market conditions this year, including a particularly difficult period last fall, are likely to mean that the System's investment return will fall below the 8% level for FY 2002. In FY 2001, due to market conditions, the System's return was a loss of 3.9%. An annual return of less than 8% implies the likely need to increase County contributions in future years beyond what has already been projected in the County's fiscal plan.

### ***Major Initiatives***

During the last quarter, the Board approved the restructuring of the domestic equity managers to eliminate the value bias and maintain a neutral position to the benchmark, the Russell 3000 index. The investment committee interviewed private equity managers to fill the alternative asset category. The Board anticipates hiring a private equity investment manager and the initial funding to be completed within the next nine months. A Request for Information was issued for the Board's investment consultant during the quarter with the Board expecting to complete contract negotiations by June 30, 2002. In addition to the above, the Board staff moved their office to 11 North Washington Street, Suite 250, in February.

# QUARTERLY REPORT

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## **EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS March 31, 2002**

### **Assets**

Equity in County's pooled cash and investments	\$7,726,146
Investments	
Northern Trust	1,765,091,759
State Street	212,928
Aetna	7,234,390
Fidelity - Elected Officials Plan	731,484
Fidelity - Deferred Retirement Option Plan	3,854,720
Total investments	1,777,125,281
Contributions receivable	3,053,705
Fixed assets, at cost:	
Office equipment	111,375
Less: accumulated depreciation	111,375
Net fixed assets	<u>-</u>
Total assets	1,787,905,132

### **Liabilities**

Benefits payable and other liabilities	1,968,470
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<b>Net assets held in trust for pension benefits</b>	<b><u>\$1,785,936,662</u></b>
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**EMPLOYEES' RETIREMENT SYSTEM**  
**STATEMENTS OF CHANGES IN PLAN NET ASSETS**  
 March 31, 2002

<b>Additions</b>	<b>Quarter</b>	<b>Fiscal YTD</b>
Contributions		
Employer	\$9,670,242	\$29,234,816
Members	3,347,586	9,482,256
Total contributions	13,017,828	38,717,072
Investment Income (loss)	30,427,065	(20,738,792)
Less investment expenses	1,455,469	4,406,823
Net investment income	28,971,596	(25,145,615)
Total additions	41,989,424	13,571,457
<b>Deductions</b>		
Retiree benefits	16,183,721	47,565,620
Disability benefits	4,312,095	12,889,135
Survivor benefits	1,004,110	3,027,092
Refunds	133,023	498,067
Administrative expenses	530,988	1,336,281
Total deductions	22,163,937	65,316,195
<b>Net increase (decrease)</b>	19,825,487	(51,744,738)
<b>Net assets held in trust for pension benefits</b>		
Beginning of period	1,766,111,175	1,837,681,400
End of period	<u>\$1,785,936,662</u>	<u>\$1,785,936,662</u>